IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
Petitioner

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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First Railroad & Banking Company of Georgia, the petitioner herein, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit which set aside and reversed the judgment of the District Court for the Southern District of Georgia granting petitioner's claim for recovery of a deficiency assessment (paid by petitioner) for the years 1961 through 1964.

OPINIONS BELOW

The Fifth Circuit's decision is reported at 514 F. 2d 675. It is reprinted in the Appendix (A 1a et seq.). The memorandum decision of the District Court, contain-

ing its findings of fact and conclusions of law, was unofficially reported at 31 AFTR 2d ¶ 73-509, at 73-1162. It is reprinted in the Appendix (A 8a et seq.).

JURISDICTION

The decision of the Fifth Circuit was entered on June 11, 1975. A petition for rehearing was timely filed by First Railroad. It was denied on October 8, 1975. An order extending to March 6, 1976, the time within which a petition for a writ of certiorari might be filed, was signed by Mr. Justice Powell on December 12, 1975.

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves" as that term is defined in Section 801(c).

A prime insurer (writing both life insurance and accident and health insurance) entered into a Reinsurance Agreement under which it ceded (transferred) a portion of its accident and health premiums and obligations to the reinsurer. Under state law the prime insurer was entitled to deduct from its total reserves the reserves attributable to the ceded premiums and obligations. If the reserves for these ceded policies are not included in total reserves of the prime insurer, its life insurance reserves are more than 50 percent of its total reserves.

The question is whether the District Court was correct in finding that the Reinsurance Agreement was founded on substantial non-tax purposes and should be given effect, with the result that the prime insurer qualified as a "life insurance company", or whether the Court of Appeals was correct in holding that the Agreement should not be given effect for tax purposes because there was no effective transfer of risk under the Agreement except in case of insolvency, and therefore the accident and health reserves must be included in the total reserves of the prime insurer, destroying its qualification to be a "life insurance company".

2. Whether it was proper for the Court of Appeals, under the "clearly erroneous" test of Rule 52 (a), F.R. Civ. P., to pay lip service to—but actually to overturn—a square finding by the trial judge that the Reinsurance Treaty involved herein was a "valid business transaction," which had substantial non-tax purposes, written in terms usual in the industry, and should be recognized for tax purposes.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.)

§ 801(a) *Life Insurance Company Defined.*—

For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50% of its total reserves (as defined in subsection (c)).

§801(b) *Life Insurance Reserves Defined.*—

(1) In General.—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * *

§801(c) *Total Reserves Defined.*—

For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

STATEMENT OF THE CASE

The case involves the application of Section 801(a) of the Internal Revenue Code of 1954 (26 U.S.C.),

which defines a "life insurance company." If a company is a "life insurance company," as defined in Section 801(a), it files its own separate income tax return, and its income is not to be included in the consolidated return of the parent company. In the present case, the parent company (the "taxpayer," your petitioner here) excluded from its consolidated return the income of a subsidiary, First of Georgia Life Insurance Company ("Georgia Credit Life," the insurer), a wholly-owned subsidiary of First of Georgia Insurance Company ("Georgia Insurance," the reinsurer), which was itself a subsidiary of the taxpayer-petitioner. The Internal Revenue Service, on the theory that Georgia Credit Life did not qualify as a life insurance company under Section 801(a) and that therefore its income should have been included in the taxpayer's consolidated return, issued a deficiency assessment. The taxpayer paid the deficiency assessment and sued for a refund. The District Court agreed with the taxpayer that Georgia Credit Life did qualify as a life insurance company; the Court of Appeals for the Fifth Circuit reversed, holding for the Government.

Whether Georgia Credit Life qualified as a "life insurance company" within the meaning of Section 801(a) has to do with the reserve-ratio test established by that Section. If its life insurance reserves were greater than 50% of its total reserves, it qualified, otherwise it did not.

The pertinent facts as found by the District Court may be summarized as follows:

Georgia Credit Life was formed as a Georgia corporation to begin business on December 31, 1958 as a life insurance company, with an initial capitalization of $400,000. During the years 1961 through 1964, Geor-

gia Credit Life was engaged both as a reinsurer and as a primary insurer writing credit life insurance and credit accident and health insurance[1] through banks, small loan companies, automobile dealers and others who sold personalty under title retention contracts. These organizations acted as agent for Georgia Credit Life for a commission on the sale of credit insurance.

Small loan companies and others licensed under the Industrial Small Loan Act were the agents selling the vast majority of the credit accident and health insurance. These agents for the credit accident and health insurance forwarded the premiums to Georgia Credit Life monthly after retaining a provisional commission, usually about 50% of the total premium. This provisional commission to these industrial loan agents was later adjusted to an agreed maximum, usually 87.5% of gross earned premium. This 87.5% of the gross earned premium was reduced by actual losses when incurred on the policies written by the agent in question.

Despite the 50% provisional commission deduction by the agents, Georgia Credit Life was required by state law to set up a reserve liability on its books in an amount corresponding to the *total* unearned premiums as the policies were issued. This requirement left Georgia Credit Life with a surplus burden corresponding to the amount of the provisional commissions. Under a valid reinsurance agreement the burden would

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[1] Credit life insurance is term insurance on the lives of debtors, guaranteeing payment of the indebtedness to the creditors of the insured debtor in the event of his death. Credit accident and health insurance guarantees payment of a debtor's monthly installments to his creditor beneficiaries in the event of his disability through accident or illness.

be reduced by the amount of any provisional commissions on reinsured policies.

On December 31, 1961, Georgia Credit Life and Georgia Insurance executed a Reinsurance Treaty[2] by which a quota share of 60% (later 70%) of all Industrial Loan and Small Loan credit accident and health insurance was to be ceded to Georgia Insurance by the primary insurer, Georgia Credit Life, "as written". Acting under this treaty, Georgia Credit Life did in fact cede the full quota share of 60% (later 70%) of this business as written to Georgia Insurance.

Under the Reinsurance Treaty, Georgia Credit Life was to receive a reinsurance commission up to a maximum of 96% of the total earned premium, reduced by actual losses on the quota share of reinsured business. The reinsurance commission receivable by Georgia Credit Life provides the source of funds from which a ratable portion of each agent's commissions and losses based upon that agent's loss experience, in the usual case to a maximum of 87.5% were paid. This provided a margin of only 8.5% of the total premium for Georgia Credit Life. This is the difference between the reinsurance commission of 96% and the 87.5% paid for the agent's loss experience and commission.

According to standard insurance accounting practices, when a credit accident and health premium under a single premium policy is paid by the insured at the time the loan is obtained, it is wholly "unearned" in the sense that the entire premium is attributable to the unexpired term of the policy. As the term of the policy expires with the passage of time, a propor-

[2] "the bona fides of which is in the true sense the subject of this litigation," according to the District Judge (A. 12a).

tionate part of the premium becomes "earned", i.e., attributable to insurance protection provided during the expired portion of the policy.

Under the Reinsurance Treaty, and in accordance with standard accounting practices, Georgia Credit Life recorded its income from premiums on an "as earned basis". Georgia Credit Life realized income for any period as indicated above after deduction of losses on the policies for that period. The individual agent who sells the credit accident and health insurance actually is charged with the losses on all policies sold by it. The formula of 87.5% available for agent's commissions and losses would ordinarily cover all losses in a retroactive adjustment. Since actual losses ran in the range of 23% to 25% or 27% of total premiums, the 87.5% formula available to the agent usually provided for all losses.

By the terms of the agreement, Georgia Credit Life ceded to Georgia Insurance 60% (later 70%) of the total premiums on all credit accident and health insurance policies written by the former. Georgia Insurance assumed, concurrent with the transfer of premiums, an unearned premium reserve liability equal to the amount of unearned premiums held by it as a result of the cession. Georgia Credit Life, having initially set up an unearned premium reserve liability on its books of 100% of the total unearned premiums, as required by state law, then took a 60% (later 70%) deduction therefrom which corresponded to the 60% (later 70%) unearned premium reserve liability set up on the books of Georgia Insurance, as permitted by state law. By making such an adjustment, Georgia Credit Life reduced its total reserves (of which credit accident and health reserves were an element) without

a proportionate reduction of its life insurance reserves. This resulted in an increase of the ratio of life reserves to total reserves to the extent that life reserves thereafter comprised more than 50% of the total reserves of Georgia Credit Life.

The Reinsurance Treaty provided for a quota share assumption of the net liability under the subject policies by Georgia Insurance. However, losses incurred under this assumption of liability were generally subject to recapture under the commission scheme set up by the Treaty. As commission for the cession of premiums, Georgia Credit Life, under the terms of the agreement, received a maximum of 96% of the premiums earned by Georgia Insurance as a result of the cession. This maximum was reduced by the amount of losses incurred by Georgia Insurance on the quota share of the reinsured business. This resulted in a dollar-for-dollar reduction of Georgia Credit Life's commission corresponding to Georgia Insurance's incurred liability, thereby ultimately placing the risk of actual loss on the reinsured business upon Georgia Credit Life in an amount up to its maximum commission.

The actual risk which was placed upon Georgia Insurance by the terms of the Treaty was an exposure to a liability for a quota share (60%, later 70%) of losses exceeding 96% of its earned premiums on the reinsured business. A further provision of the Treaty permitted Georgia Insurance to carry forward, as a claim against Georgia Credit Life's commission in subsequent accounting periods (quarterly), any deficit arising from losses incurred by Georgia Insurance exceeding 96% of the reinsurer's earned premium during any particular quarter. Thus, assuming solvency of

Georgia Credit Life, Georgia Insurance would eventually recapture all losses incurred by reason of its assumption of the quota share liability. Therefore, the risk of loss upon Georgia Insurance was, as the District Court found, in actuality remote. In order for Georgia Insurance to sustain permanent out-of-pocket losses on liability under the subject policies, there would have to be valid claims exceeding 96% of the reinsurer's earned premium,[3] and additionally, Georgia Credit Life would have to be insolvent so as to preclude recapture of those losses in subsequent accounting periods.

The District Court found that despite this transfer of minimal risk under the Reinsurance Treaty, there were substantial insurance purposes for entering into the arrangement. These mainly had to do with the limited surplus position of Georgia Credit Life as well as the limited experience in the credit accident and health business of its managerial team. When Georgia Credit Life was formed by Georgia Insurance in 1958, Georgia Insurance was precluded by state law from entering into the credit life business. Georgia Insurance's agency force, however, was demanding an expanded coverage which would include credit life as well as credit accident and health for its customers. There was therefore, as a business matter, the necessity of forming a subsidiary to provide these services.

Shortly after Georgia Credit Life began providing these services, the management, as well as the State insurance examiners, realized that its capital structure would be increasingly burdened by the growing volume of business which the company was writing be-

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[3] This contingency never actually occurred during the life of the Treaty.

cause of the deficits caused by provisional payments of commissions to the agents. As the volume of business increased, the ratio of net written premiums to policyholder surplus increased. Reduction of this ratio was the sole test applied by the Insurance Commissioner to determine whether the company should be allowed to expand through new business which would further burden the surplus. This reduction was accomplished by entering into the Reinsurance Treaty, the terms of which provided for an effective transfer of a portion of the burden to Georgia Insurance's capital structure. The District Judge found that the result of the Reinsurance Treaty was that Georgia Credit Life was thereafter capable of, and in fact accomplished, a threefold increase in the volume of credit accident and health business. This rapid expansion was desirable to increase profits and, additionally, to provide the inexperienced management team with a firmer basis for loss prediction by improving the reliability of actuarial averages.[4]

The District Court found that there was an additional business purpose for entering into the Treaty—that it tended to insure the solvency of Georgia Credit Life by protecting its surplus from depletion through payment of excessive losses. In the event of excessive losses, which is what in reality reinsurance is designed to protect against, 60% (later 70%) of the liability would be satisfied initially from the excess surplus held by Georgia Insurance. Although these losses would

[4] Loss prediction in the credit accident and health industry is based upon average loss experiences. The reliability of these averages improves with an increase in the number of persons covered by a particular company. This is true because maximizing the sample minimizes the impact of unusual single losses with respect to the overall averages.

eventually be recaptured, the recapture would entail no surplus drain but rather an adjustment to Georgia Credit Life's reinsurance commissions which were calculated with reference to earned premiums. Thus the capital structure of Georgia Credit Life was insulated against the risk of excessive losses, and in such an event the company would remain solvent, enabling it to recoup commission losses through retroactive adjustment of provisional commissions paid to its agents.

An important finding of the District Court was that the subject Treaty also inured to the advantage of the policyholder, in that the arrangement subjected the substantial surplus of the parent company to policyholder claims. This was a particularly valuable protection should the subsidiary become insolvent, because the insolvency clause of the Treaty, which was required by state law, provided for continued liability of the parent for 60% (later 70%) of the claim. The District Court pointed out as "noteworthy" that this arrangement was approved by the Insurance Commissioner of the State of Georgia whose regulatory function is geared to protection of the policyholder. (A 16a)

Finally, in a finding basic to this case, the District Judge found that the Reinsurance Treaty was under terms comparable to, and patterned after, reinsurance rates and terms that are usual in the industry between companies dealing at arms length. The advantages accruing to Georgia Credit Life pursuant to the Treaty would have been the same regardless of the reinsurer. The obvious advantage to the parent, Georgia Insurance, was an increase in investment income corresponding to its reinsurance premium.

The accounting methods utilized by Georgia Credit Life under the Treaty were specifically found to be con-

sistent with standard insurance accounting principles and practices.

The District Court held that since state law required accident and health reserves to be maintained by the company holding the unearned accident and health premiums (Georgia Insurance, in this case), "the reserves should follow the premiums" and should be attributed to that company. (A 16a) Similarly, state law required life insurance reserves to be maintained by the company holding the unearned life insurance premiums (Georgia Credit Life), and therefore the life reserves were attributable to Georgia Credit Life. The District Court found that the applicable state law, Georgia Code Ann. § 56-413(5), provided that an insurance company reinsuring all or a portion of its risk with a qualified reinsurer was entitled to take a deduction from its reserve liability in an amount corresponding to the amount of insurance ceded, under the circumstances here.

The District Judge held that a reinsurance agreement such as is here involved, providing for cession of a quota share of the premiums whereby the assuming company accepts a quota share liability and sets up the reserve thereon, "may not be ignored by the Internal Revenue Service for tax purposes if there were legitimate business purposes for entering into the agreement." (A 17a) And since there were legitimate business purposes, as was specifically found by the District Court, the deduction taken by Georgia Credit Life from its credit accident and health reserve liability (in the amount of the reserve liability set up—and required to be set up—by Georgia Insurance) was a proper accounting procedure accurately reflecting the transaction.

The District Court thus found that during the years 1961-1964, the life insurance reserves properly maintained by Georgia Credit Life comprised more than 50% of its total reserves, and therefore Georgia Credit Life qualified as a "life insurance company" under Section 801(a).

The Fifth Circuit, in a 2-1 decision, reversed. It held that because of the recapture-of-losses provisions of the Reinsurance Treaty, the reinsurer did not bear any risks (except of the insolvency of Georgia Credit Life), and that the risk remained with Georgia Credit Life. And then, deferring to and accepting the Seventh Circuit's disposition of the Section 801 issue in *Economy Finance Corp.* v. *United States,* 501 F. 2d 466 (1974), cert. den. 420 U.S. 947 (1975), the Court of Appeals majority here said (A 6a) that the Seventh Circuit in that case

> "concluded that Congress intended by that section to charge the company *actually* experiencing the risk of claim losses with the corresponding 'reserves'—for the purpose of determining who was in the insurance business—as opposed to the loan business."

The Fifth Circuit majority accepted the "reasoning and result" of *Economy Finance* (A 6a), charged the accident and health reserves back to Georgia Credit Life, and reversed. Judge Roney dissented, for the reasons set forth in the dissent of Judge Stevens in *Economy Finance*—that it was the reinsurer, Georgia Insurance, which was required by state law to commit its assets to reserve status for insurance purposes (and to pay taxes on the reserve income). It was the reinsurer, said Judge Roney, which "bore all of the legal consequences of required reserves, the reinsured none."

(A 7a) Therefore the accident and health reserves should be attributed to Georgia Insurance, as had been held by the trial judge, with the result that Georgia Credit Life should qualify under Section 801(a).

REASONS FOR GRANTING THE WRIT

I. There Is a Square Conflict of Federal Courts.

A square conflict now exists between two Courts of Appeals (the Fifth and the Seventh) on the one hand and the Court of Claims on the other, on the issue presented here. That issue is an interpretation of § 801(a) of the Internal Revenue Code. Determination of that issue is, from the taxpayer's point of view, critical to the insurance industry, and from the Government's point of view, important to the revenue.

A petition for a writ of certiorari has been filed by the Government in one of the two Court of Claims cases involved, *United States* v. *Consumer Life Insurance Company,* No. 75-1221, filed February 25, 1976, and we are advised that a similar petition will be filed in the other Court of Claims case, which will be *United States* v. *Penn Security Life Insurance Company,* No. ———. In its petitions in those cases, the Government sets forth the importance to the revenue and states that conflict on this widely litigated issue requires resolution by this Court in order that there be a uniform national rule. We agree with the Government.

The Fifth Circuit in this case, and the Seventh Circuit in *Economy Finance Corp.* v. *United States,* 501 F. 2d 466 (1974), cert. den. 420 U.S. 947 (1975), both held that the intention of Congress in enacting § 801(a) required that the accident and health reserves "follow the risk." Ignoring the plain words of the statute that the reserves—the actual reserves—were to determine

a company's qualification to be a "life insurance company," the Fifth Circuit in this case analyzed the reinsurance arrangement and determined that the ultimate risk lay on the prime insurer rather than the reinsurer; the Court then held that the accident and health reserves should (contrary to actual fact) be attributed back to the prime insurer, thereby causing the life reserves to constitute less than 50% of total reserves and destroying the prime insurer's qualification to be a "life insurance company."[5]

The Fifth Circuit in this case specifically adopted the reasoning of the Seventh Circuit in *Economy Finance*, saying (A 6a): "We accept its reasoning and result."

The Court of Claims, on the other hand, specifically refused to adopt the Seventh Circuit's reasoning in *Economy Finance* when it decided, on October 22, 1975, the two cases of *Penn Security Life Insurance Co.* v. *United States* and *Consumer Life Insurance Co.* v. *United States*, reported at 524 F. 2d 1155 and 524 F. 2d 1167 respectively. The Court of Claims, saying in *Penn Security* (524 F. 2d at 1161) that "we cannot accept the rationale of the majority" in the *Economy Finance* case, analyzed at length the intent of Congress in enacting § 801 and, disagreeing with the Seventh Circuit (and of course with the Fifth Circuit in the present case), said (p. 1163):

> ". . . it seems to us preferable to accept the statute as written, leaving to Congress the function

[5] In each case, the Court of Appeals reversed the District Court, which had held the reinsurance arrangement to be consistent with § 801, and in each case it was a 2-1 vote in the Court of Appeals (Judge Stevens dissenting in the *Economy Finance* case, Judge Roney dissenting in this case).

of closing loopholes (if they exist) or restructuring the provision in greater detail. The section is technical and specific. If there be some anomalies under the statute as it stands, the Congress is in far better position to clarify its purpose and to harmonize § 801 with the other provisions of the insurance portion of the Code."

The words quoted above embody the issue before this Court. What has happened in the case at bar in the Fifth Circuit (and in *Economy Finance* in the Seventh Circuit) is that the Court of Appeals has taken a federal statute which is clear on its face and has ignored that clear mandate, in order to achieve a purpose that the Court believes the Congress would espouse. Judge Roney, dissenting in this case, put it in simple terms (A 7a):

> "Had Congress desired to define a life insurance company in terms of the ultimate risk, it could easily have done so. The judicial overlay to that effect is an unnecessary intrusion into the legislative process. Reserves being the lodestar, they should control. Although the majority holds there was no substance to the reinsurance agreement, without even a bow to the clearly erroneous rule, the district court having found factually to the contrary, reinsurer was required to commit its assets to reserve status for insurance purposes and to pay tax on the reserve income for tax purposes. It bore all of the consequences of required reserves, the reinsured none. This decision throws confusion into a statutory enactment that deserves simpler application."

The Fifth Circuit here, like the Seventh Circuit in *Economy Finance*, has federalized a matter committed by Congress to state law. Section 801(c) of the Internal Revenue Code, printed at p. 4, supra,

defines "total reserves," and subparagraph (3) thereof ("all other insurance reserves required by law") is the clause involved in the Fifth Circuit's decision; the Fifth Circuit has added back the accident and health reserves into the prime insurer's total reserves. But the phrase "required by law" in Section 801(c)(3) means *state law*, as indeed the Fifth Circuit itself stated in a leading case, *Lamana-Panno-Fallo Industrial Insurance Co.* v. *Commissioner,* 127 F. 2d 56 (C.A. 5th, 1942). That case held that when a state insurance commissioner interpreted a statute as permitting him to allow industrial insurance companies to hold a lesser amount of reserves than ordinary life insurance companies for a temporary period, and the Commissioner of Internal Revenue refused to allow a deduction for the lesser reserves because (in the Commissioner's opinion) they were not large enough and therefore not "required by law," the Commissioner was wrong. The Court stated (127 F. 2d at 58): "We find no provision in Statute or Regulation looking to a demand on the Commissioner's part for larger reserves than the state has required."

The tie to state law was put in this fashion by the dissent in the *Economy Finance* case, 501 F. 2d at 483:

> "Congress could have selected any one of several different tests for deciding when the life insurance portion of a company's business is sufficient to characterize the enterprise as a 'life insurance company' for tax purposes. It might have used the number of life policies written, the amount of premium income, the face value of its policies, or possibly some combination of different yardsticks. Instead, it chose to attach significance to

> the relative importance of the company's life insurance reserves.
>
> Perhaps another test would have been preferable, but the reserve-ratio test does have certain advantages. Insurance companies are regulated by state authorities who require them to maintain adequate reserves. There is, therefore, an independent basis for believing that the amount of an insurance reserve is a realistic measure of the insurance risks the company has been paid to assume."

The majority of the Fifth Circuit, in the case at bar, turns out to be in the embarrassing position of relying for support not only on the Seventh Circuit's opinion in *Economy Finance,* so specifically criticized by the Court of Claims in *Penn Security,* but also (see footnote 11 of the opinion, at A 6a) on the trial judge's opinion in *Consumer Life Insurance Co.* v. *United States,* which subsequently was reversed by the Court of Claims en banc on appeal, 524 F. 2d 1167. The Fifth Circuit also questioned the trial judge's opinion in *Penn Security* (which had applied § 801 as written), only to have the Court of Claims—again sitting en banc—subsequently sustain the trial judge and virtually adopt his opinion, 524 F. 2d 1155.

Thus the conflict could not be sharper. The Fifth Circuit was clear and candid in its statement; it refused to apply the plain reserves-ratio test of the statute and instead adopted the risk-attribution test of the Seventh Circuit, relying on "underlying Congressional intent and an analysis of the arrangement in the light of practical realities." (A 6a)

The issue on which this conflict is presented is important. Although the Fifth Circuit did not men-

tion it, the Reinsurance Treaty here involved (though between related companies) was specifically found by the trial judge to be in "terms comparable to, and patterned after, reinsurance rates and terms that are usual in the industry between companies dealing at arms length," and the advantages accruing to the prime insurer under the Treaty would have been the same "regardless of the reinsurer." (A 16a) If the Fifth Circuit majority opinion is correct in its view that it may take a form of reinsurance agreement "usual in the industry," which results in the prime insurer's qualifying under the literal and the plain meaning of the statute, and interpret the word "reserves" in a manner contrary to actual fact in order to reach a desired result (thus destroying the qualification), it will create chaos in the insurance industry. For example, an article in *Best's Review* for September, 1975 ("Questions Again Arise Concerning the Qualification of Credit Life Insurance Companies for Federal Income Tax Purposes," by Lenrow, Milo, and Zampino, p. 68), discussing these cases, points out that the use of the risk-attribution test involves not only the qualification vel non of companies under Section 801(a), tremendously important in its own right, but also other questions under the Internal Revenue Code. As the authors say, pp. 76-77:

> "The issue is extremely complex. The main difficulty of the 'risk attribution' principles is that it leaves many important questions unanswered.
>
> (a) If certain reserves of A are attributable to B for qualification purposes, are these same reserves then removed from A's qualification ratio?
>
> (b) If such reserves merely succeed in disqualifying B, would the end result be to dis-

qualify B's actual income (solely from life insurance sources) from life insurance tax treatment or to leave the income from these 'non-life' reserves in A, where it could be subject to the favorable life insurance tax treatment?

Not only are the answers complex, but the confusion that could surround the application of such answers could lead to further confusion."

Still other problems are suggested by the Court of Claims in its recent *Penn Security* decision. Criticizing the importation by the Seventh Circuit of the risk-attribution test into a statutory scheme that does not mention it, the Court of Claims said (524 F. 2d at 1163) of the *Economy Finance* approach followed here by the Fifth Circuit:

> "In addition, the consequences of the general rule laid down by the Court of Appeals are uncertain and unclear. Judge Stevens thought the majority's standard might well exclude from coverage under § 801 such a common form of life insurance as term insurance. See 501 F. 2d at 486 n.7. There may be other untoward gaps or disharmonies. We cannot tell because the consequences of departing from the text of § 801 are opaque."

The issue now has been focused by the conflict of federal courts. This Court should put an end to the confusion.

II. The Court of Appeals Has Violated the "Clearly Erroneous" Rule of F.R. Civ. P. 52(a).

Rule 52(a) of the Federal Rules of Civil Procedure provides:

> "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given

to the opportunity of the trial court to judge of the credibility of the witnesses."

This "clearly erroneous" rule applies to intention and purpose, such as the non-tax purposes of the Reinsurance Treaty involved in this case. And it applies to appeals by the Government fully as much as to appeals by private parties. Thus, in *United States* v. *Yellow Cab Co.,* 338 U.S. 338, 341-2 (1949), the Court said:

> "Findings as to the *design, motive and intent* with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them. (Emphasis added)
>
> * * *
>
> It ought to be unnecessary to say that Rule 52 applies to appeals by the Government as well as to those by other litigants."

Yet in the present case, the Fifth Circuit overturned a square finding of business purpose by the trial judge who had heard the evidence and had evaluated the testimony, thus violating the "clearly erroneous" mandate of Rule 52(a) in precisely the manner condemned by the Eighth Circuit in a leading case, *St. Louis Typographical Union* v. *Herald Co.,* 402 F. 2d 533, 559 (8th Cir., 1968):

> "It is not the function of the court of appeals to reevaluate evidence presented in the trial court, and the reviewing court cannot substitute its judgment for first-hand evaluation."

The decision of the District Judge phrased the issue as being that the "bona fides" of the Reinsurance Treaty constituted "in the true sense the subject of this litigation." (A 12a) He found the Treaty to be

completely bona fide, discussing in detail the non-tax reasons for entering into the Treaty. Having satisfied himself on its bona fides, the District Judge could see no reason not to apply the statutory criteria. As he said (A 16a): "There is irrefutable logic in the assertion that the reserves should follow the premiums."

The Court of Appeals, saying it did not "question the validity of everyone's business reasons for establishing this Treaty arrangement" (A 5a), then said:

> "But the issue is not whether the Treaty will be recognized for tax purposes *vel non*, but *given* the Treaty, what are its tax consequences, and that depends on whether it really amounts to reinsurance as contemplated in the Act."

The phrasing, "whether it really amounts to reinsurance as contemplated in the Act," appears to be an effort to turn the issue into a question of law, an interpretation of a federal statute, so that the "clearly erroneous" rule would not apply. See, e.g., *Stevenot* v. *Norberg,* 210 F. 2d 614 (9th Cir., 1954) and *American Nat. Bank* v. *United States,* 421 F. 2d 442 (5th Cir. 1970) cert. den. 400 U.S. 819 (appellate court is not bound by the "clearly erroneous" rule where the finding is one dealing not with disputed facts but rather with the effect of a transaction based on undisputed facts). The Fifth Circuit then held "there was no substance to the agreement as reinsurance." (A 5a) Judge Roney, in dissent, protested that this *was* a factual matter subject to the "clearly erroneous" test:

> "The reinsurer was required to commit its assets to reserve status for insurance purposes and to pay tax on the reserve income for tax purposes. It bore all of the legal consequences of required reserves, the reinsured none." (A 7a)

The fact that the majority can say that "whether it really amounts to reinsurance as contemplated in the Act" is *the issue* in this case is the signal as to how the Fifth Circuit majority committed this violation of Rule 52(a). It asked the wrong question and therefore came to the wrong answer. *The word "reinsurance" does not occur in the Act,* in the portion of the statute involved in this case. The word occurs only in § 801(b)(1)(B), part of the definition of "life insurance reserves." But there is no issue in this case as to life insurance reserves; the Government and the taxpayer agreed on the amount of "life insurance reserves," in a stipulation filed in the case (Record, p. 29).

We see now that the basic holding of the Fifth Circuit, that "there was no substance to the agreement as reinsurance," was—as the dissent said—a *factual* matter. Judge Roney noted (A 7a) that

> "the majority holds there was no substance to the reinsurance agreement, without even a bow to the clearly erroneous rule, the district court having found factually to the contrary. . . ."

It is thus completely incorrect that what this case involves is an interpretation of a federal statute, as to which the appellate court is free to ignore the trial court's findings. We have here a trial court's factual analysis of a business arrangement. Rule 52(a) required that the District Court's analysis be accepted by the Court of Appeals unless it was "clearly erroneous," and the Court of Appeals did not claim that it was.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPPEALS,
FIFTH CIRCUIT.

No. 73-3184.

FIRST RAILROAD & BANKING COMPANY OF GEORGIA,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA, *Defendant-Appellant.*

June 11, 1975.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF GEORGIA.

Before BROWN, *Chief Judge,* and GODBOLD and RONEY, *Circuit Judges.*

JOHN R. BROWN, *Chief Judge:*

The Government appeals from a judgment granting First R.R. & Banking Company of Georgia's (taxpayer's) prayer for recovery of a deficiency assessment, paid for the years 1961 through 1964. It is argued the District Court erroneously held taxpayer was entitled to exclude the income of a sub-subsidiary, First of Georgia Life Insurance Company (Insurer) [1] from its consolidated return. Sections 801 and 1504(b)(2).[2] We agree and reverse.

Both on appeal and in the District Court, the Government challenges Insurer's ability to satisfy the 50% reserve ratio

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[1] A wholly-owned subsidiary of First of Georgia Insurance Company (Reinsurer). Parent-taxpayer, in turn, owns 100% of Reinsurer.

[2] All statutory references herein are to the Internal Revenue Code of 1954 unless otherwise specified.

test of § 801.[3] The success of the challenge depends upon whether a Reinsurance Treaty between Insurer and Reinsurer effectively transferred a substantial block of non-

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[3] Sec. 801. (a) *Life insurance company defined.*—For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

(b) *Life insurance reserves defined.*—

(1) *In general.*—For purposes of this part the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * *

(c) *Total reserves defined.*—For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves.

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

The term "total reserves" does not include deficiency reserves (within the meaning of subsection (b)(4)).

qualifying[4] accident and health (A&H) insurance reserves from Insurer to Reinsurer, thereby raising the proportion of life insurance reserves above the 50% level.

Reinsurer desired to enter the credit[5] life and A&H business. Georgia law requires an insurance company writing such policies to qualify as a life insurance company. Insurer was organized for the purpose of qualifying, because Reinsurer could not.

Insurer was capitalized with $400,000. Georgia requires that insurers maintain cash revenues to cover payment of potential insurance liabilities. These reserves must equal the total "unearned premium".[6] Assets exceeding reserves are "surplus", and Georgia insurance officials measure a company's solvency by comparing surplus to reserves. The record shows that Georgia permits reserves to reach a level one and a half to two times surplus.

In Insurer's case, this limit was approached rather quickly because of a "provisional commission" arrangement with its agents. Under the arrangement, each agent initially retained 50% of all premiums collected—but Insurer was nevertheless required to maintain reserves equal to 100% of the policy-premiums. As Insurer wanted to undertake a greater volume of business, it entered into the Reinsurance Treaty with Reinsurer, its parent.

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[4] Not "noncancellable" for § 801(a)(2) purposes.

[5] Credit insurance is a form of credit-consumer protection which guarantees payments on the subject debt in the event of the borrower's death or disability.

[6] Credit insurance is generally 100% prepaid—as the loans' durations are generally short. The premium is "earned" by providing insurance coverage—thus the reserve required for each policy decreases as its term passes.

Basically, the Treaty provided that 60% [7] of Insurer's A&H policies (i.e., 60% of each policy) was reinsured by Reinsurer—but none of the life policies. Insurer was then entitled, under Georgia law, to continue writing insurance, because the corresponding A&H reserves shifted to Reinsurer, while Insurer's surplus remained the same.

But non-basically, the true nature of the Reinsurance Treaty can only be seen when the commission arrangement is detailed. Reinsurer agreed to pay Insurer a 96% commission on all business the Reinsurer received under the Treaty. The commission was payable, however, only at the end of the coverage period—and then only after "adjustment". And the adjustment was a dollar-for-dollar deduction of any loss (paid-out claim) experienced under the policies. Further, if the claim-loss exceeded the permium on that particular policy, Reinsurer was further entitled to set-off the excess against commissions payable on policies against which no claims had been asserted. And still further, if the claim-loss for any accounting period exceeded commission payable for that period, the excess could be carried forward, and set-off against succeeding commission payments.

In short, the economic substance of the arrangement was that as between taxpayer's issue, Insurer suffered or enjoyed fate's capricious precipitation of policy-claims, while the Reinsurer, for a 4% fee, provided in effect a line of credit in case periodic claims reached abnormally high levels. And since the record shows that claim-losses over time averaged only about 22% of total premiums received there was no likelihood that Reinsurer as an economic matter would ever sustain any losses. Reinsurer under the arrangement did not bear any risks except the outside

[7] The Treaty was later renegotiated for the purpose of ceding 70% of the A&H business. However, this amendment is irrelevant to any of the substantive issues under consideration.

possibility of insolvency of Insurer.[8] We hold therefore there was no substance to the agreement as reinsurance.

We in no way denigrate the salutary holding of *Gregory* v. *Helvering*, 1935, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596, that taxpayers are free to arrange their affairs in a way which entitles them to tax advantages. Nor do we question the validity of everyone's business reasons for establishing this Treaty arrangement—indeed we have carefully explained it, *ante*. But the issue is not whether the Treaty will be recognized for tax purposes *vel non*, but *given* the Treaty, what are its tax consequences and that depends on whether it really amounts to reinsurance as contemplated in the Act.

The Seventh Circuit recently considered this credit-insurance reinsurance reserve problem.[9] But they did not re-

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[8] As the District Court put it:

> Thus, assuming solvency of Georgia Credit Life, Georgia Insurance would eventually recapture all losses incurred by reason of its assumption of the quota share liability. Therefore, the risk of loss upon Georgia Insurance was, in actuality, remote. In order for it to sustain permanent out of pocket losses on liability under the subject policies, there would have to be valid claims exceeding 96% of the reinsurer's earned premium; and additionally, Georgia Credit Life would have to be insolvent so as to preclude recapture of those losses in subsequent accounting periods.
>
> Despite this transfer of minimal risk under the Reinsurance Treaty, there were substantial non-tax purposes for entering into the arrangement.

App. 249-50.

The fact that the state insurance authorities permitted the "reserves" to be handled as done by Insurer and Reinsurer cannot overcome these economic realities.

[9] Economy Finance Corp. v. United States, 7 Cir., 1974, 501 F.2d 466, cert. denied, 1975, 420 U.S. 947, 95 S.Ct. 1328, 43 L.Ed.2d 425.

serve the question—they considered very carefully the legislative history of § 801. They concluded that Congress intended by that section to charge the company *actually* experiencing the risk of claim losses with the corresponding "reserves"—for the purpose of determining who was in the insurance business—as opposed to the loan business.[10]

We have examined the Seventh Circuit's rationale—as well as Judge Stevens' dissent and the various post-argument papers submitted by all the parties in our case. We think the majority's is the sounder approach—relying as it does on underlying Congressional intent and an analysis of the arrangement in the light of practical realities. We accept its reasoning and result.[11]

Reversed.

RONEY, *Circuit Judge* (dissenting):

I respectfully dissent for the reasons set forth in Judge Alaimo's opinion in this case, and in Judge Steven's dissent in *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (7th Cir. 1974), cert. denied, 420 U.S. 947, 95 S.Ct. 1328, 43

> [10] Here, the taxpayers admittedly sought surplus aid but they also desired to function as the insurer on these H&A policies . . . As a result, the reinsurance treaties served an interim loan function but did not serve to spread the insurance risk.

Id. at 477.

[11] Our result is also supported by Consumer Life Ins. Co. v. United States, Ct.Cl., Dec. 13, 1974, 75-2 U.S.T.C. ¶ 9113, —— A.F.T.R.2d —— —although that Court employed a somewhat different rationale. And we are not unaware of *Penn Security Life Ins. Co.* v. *United States,* Ct.Cl., 1973, 7 CCH 1973 Stand.Fed.Tax Rep. ¶ 7908. Each case is a Trial Judge's opinion— and currently under review by the en banc court. However, we point out in passing that (i) the *Consumer Life* opinion questioned the completeness of the factual record in *Penn Security,* and (ii) *Penn Security* relied in large part on *Economy Finance Corp.* v. *United States,* S.D.Ind., 1972, 72-2 U.S.T.C. ¶ 9634, 30 A.F.T.R.2d 72-5446, which, of course, since has been reversed in the opinion we approve.

L.Ed.2d 425 (1975). Had Congress desired to define a life insurance company in terms of the ultimate risk, it could have easily done so. The judicial overlay to that effect is an unnecessary intrusion into the legislative process. Reserves being the lodestar, they should control. Although the majority holds there was no substance to the reinsurance agreement, without even a bow to the clearly erroneous rule, the district court having found factually to the contrary, there was certainly legal substance. The reinsurer was required to commit its assets to reserve status for insurance purposes and to pay tax on the reserve income for tax purposes. It bore all of the legal consequences of required reserves, the reinsured none. This decision throws confusion into a statutory enactment that deserves simpler application.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF GEORGIA
AUGUSTA DIVISION

CIVIL ACTION No. 1738

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, *Plaintiff*

v.

UNITED STATES OF AMERICA, *Defendant*

(FILED APRIL 9, 1973)

Memorandum Opinion

This is a civil action for the recovery of income taxes paid by the plaintiff pursuant to a deficiency assessment for the years 1961-1964. The action arises under the Internal Revenue Code of 1954, 26 U.S.C. § 1, *et seq.* This Court's jurisdiction to determine the issues herein is predicated upon 28 U.S.C. § 1346(a)(1).[1]

For the years 1961-1964, the plaintiff filed a consolidated U.S. Corporation Income Tax Return (Form 1120) which included the taxable income of a group of affiliated corporations of which the plaintiff was a common parent. For each of the years in question, First of Georgia Life Insurance Company (hereinafter referred to as Georgia Credit

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[1] 28 U.S.C. § 1346(a)(1) provides as follows: "(a) The district courts shall have original jurisdiction, concurrent with the Court of Claims, of:

> (1) Any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws; . . . ."

Life), an insurance company wholly owned by the plaintiff's wholly owned subsidiary First of Georgia Insurance Company (hereinafter referred to as Georgia Insurance) filed a separate return (Form 1120 L) basing action upon the assumption that it qualified as a life insurance company within the ambit of § 801(a), Internal Revenue Code of 1954, 26 U.S.C. § 801(a).[2] By letter dated April 21, 1969, the Internal Revenue Service notified the plaintiff of a deficiency assessment in the amount of $119,080.11. This deficiency was based upon the determination that the taxable income of Georgia Credit Life should have been included in the consolidated return of the plaintiff for the reason that Georgia Credit Life did not qualify as a life insurance company as defined by § 801(a). After payment of the deficiency assessment, the plaintiff filed claims for refund with the District Director of Internal Revenue for the District of Georgia. This claim was disallowed and the plaintiff timely commenced an action for recovery of the claim plus statutory interest thereon.

The sole issue, here, is whether the action of the Internal Revenue Service in increasing the consolidated taxable income of the plaintiff and its subsidiaries by the net income from Georgia Credit Life upon the premise that Georgia

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[2] 26 U.S.C. § 801(a) provides: "(a) Life insurance company defined.—For purposes of this subtitle, the term 'life insurance company' means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b)), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c))."

Credit Life was not a life insurance company, was permissible. If it is determined that Georgia Credit Life was not a life insurance company as defined by § 801(a), the computation made by the Internal Revenue Service including its taxable income with that of the plaintiff and its subsidiaries was correct and the plaintiff would be entitled to no recovery. Conversely, if it is determined that Georgia Credit Life was a life insurance company as defined by § 801(a), the plaintiff would be entitled to recover such sums found to be due under recomputation by the Internal Revenue Service as stipulated by the parties to this action.[3] Whether or not Georgia Credit Life was a life insurance company within the meaning of § 801(a) depends upon the ratio of life insurance reserves to total insurance reserves. If the life reserves were greater than 50% of the total reserves, Georgia Credit Life was a life insurance company; if the life reserves were less than 50% of the total reserves, Georgia Credit Life would not qualify as a life insurance company. The determination of the proper reserve ratio depends in turn upon the validity, for tax purposes, of a reinsurance scheme whereby Georgia Credit Life purportedly reduced its total reserve (the denominator of the fraction) *vis a vis* its life reserves (the numerator of the fraction) by transferring a portion of its credit accident and health business to its parent, Georgia Insurance. The plaintiff takes the position that there were valid business

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[3] *See* Paragraph 10 of Stipulation which provides in part:

"If the Court finds that Georgia Credit Life was a life insurance company, the Internal Revenue Service will recompute plaintiff's taxable income and the refund due by excluding the taxable income of Georgia Credit Life therefrom and by including for the year 1963 intercorporate dividends of $7,500 from Georgia Credit Life net of the dividends received deduction. Such computation will be subject to the review and approval of the plaintiff. In the event of disagreement on the computation between the parties, the parties will submit the matter to the Court for a decision."

purposes for the initiation and implementation of the plan while the defendant contends that any purported business purposes were slight, if not wholly illusory.

Findings of Fact

During the years 1961-1964, Georgia Credit Life was engaged as a primary insurer (as well as a reinsurer) writing both credit life and credit accident and health insurance. Credit life insurance is term insurance on the lives of debtors which, under the terms of the policy, guarantees payment of the indebtedness to the creditors of the insured in the event of the latter's death. Credit accident and health insurance guarantees payment of a debtor's monthly installments to his creditor beneficiaries in the event of the debtor's disability through accident or sickness. Approximately 90% of Georgia Credit Life's credit life and credit accident and health insurance business was obtained by various lenders who acted as agents of Georgia Credit Life for the sale of credit insurance. These agents forwarded the premiums received from their customers to Georgia Credit Life after deducting a provisional commission which in the usual case approximated 50% of the premium dollar. This provisional commission was held by the agent against the actual commission which was paid as the premiums became earned.[4] The actual commission, in the usual case, was computed on a formula representing 87½% of the total earned premium with a deduction for the actual loss experience of the individual agent's customers during the accounting period. Despite the 50% provisional com-

[4] According to standard insurance accounting practices, when a credit accident and health premium under a single premium policy is paid by the insured at the time the loan is obtained, it is wholly "unearned" in the sense that the entire premium is attributable to the unexpired term of the policy. As the term of the policy expires with the passage of time, a proportionate part of the premium becomes "earned," *i.e.*, attributable to insurance protection provided during the expired portion of the policy.

mission deduction by the agents, Georgia Credit Life was required to set up a reserve liability on its books in an amount corresponding to the total unearned premiums as the policies were issued. This requirement placed Georgia Credit Life in a deficit position by creating a surplus burden corresponding to the amount of the provisional commissions.

On December 31, 1961, a Reinsurance Treaty (the bona fides of which is in the true sense the subject of this litigation) was entered into between Georgia Credit Life and its parent corporation, Georgia Insurance. The purpose of this agreement was to provide for the transfer of certain credit accident and health premiums from Georgia Credit Life to Georgia Insurance together with the concomitant unearned premium reserve liability which was required to be maintained by state law as a fund from which to pay claims of policyholders.

By the terms of the agreement, Georgia Credit Life ceded to Georgia Insurance 60% (later 70%) [5] of the total premiums on all credit accident and health insurance policies written by the former. Georgia Insurance assumed, concurrent with the transfer of premiums, an unearned premium reserve liability equal to the amount of unearned premiums held by it as a result of the cession. Georgia Credit Life, having initially set up an unearned premium reserve liability on its books of 100% of the total unearned premiums, then took a 60% (later 70%) deduction therefrom which corresponded to the 60% (later 70%) unearned premium reserve liability set up on the books of Georgia Insurance. By making such an adjustment, Georgia Credit Life was able to reduce its total reserves (of which credit accident and health reserves were an

[5] Under the terms of the Treaty, Georgia Credit Life was given the option to increase the percentage of the accident and health premiums to be ceded by 10%. This option was exercised shortly after the commencement of the arrangement.

element) without a proportionate reduction of its life insurance reserves. This resulted in an increase of the ratio of life reserves to total reserves to the extent that life reserves thereafter comprised more than 50% of the total reserves and gave rise to Georgia Credit Life's assertion that it qualified as a life insurance company under the qualifying formula of § 801(a).

The Treaty in question further provided for a quota share assumption of the net liability under the subject policies by Georgia Insurance. However, losses incurred under this assumption of liability were generally subject to recapture under the commission scheme set up by the Treaty. As commission for the cession of premiums, Georgia Credit Life, under the terms of the agreement, received a maximum of 96% of the premiums earned by Georgia Insurance as a result of the cession. This maximum was reduced, then, by the amount of losses incurred by Georgia Insurance on the quota share of the reinsured business. This resulted, of course, in a dollar for dollar reduction of Georgia Credit Life's commission corresponding to Georgia Insurance's incurred liability thereby ultimately placing the risk of actual loss on the reinsured business upon Georgia Credit Life in an amount up to its maximum commission. Thus, the actual risk which was placed upon Georgia Insurance by the terms of the treaty was an exposure to a liability for a quota share (60% and later 70%) of losses exceeding 96% of its earned premiums on the reinsured business. A further provision of the Treaty permitted Georgia Insurance to carry forward as a claim against Georgia Credit Life's commission in subsequent accounting periods (quarterly) any deficit arising from losses incurred by Georgia Insurance exceeding 96% of the reinsurer's earned premium during any particular quarter. Thus, assuming solvency of Georgia Credit Life, Georgia Insurance would eventually recapture all losses incurred by reason of its assumption of the

quota share liability. Therefore, the risk of loss upon Georgia Insurance was, in actuality, remote. In order for it to sustain permanent out of pocket losses on liability under the subject policies, there would have to be valid claims exceeding 96% of the reinsurer's earned premium;[6] and additionally, Georgia Credit Life would have to be insolvent so as to preclude recapture of those losses in subsequent accounting periods.

Despite this transfer of minimal risk under the Reinsurance Treaty, there were substantial non-tax purposes for entering into the arrangement. These mainly had to do with the limited surplus position of Georgia Credit Life as well as the limited experience in the credit accident and health business of its managerial team. When Georgia Credit Life was formed by Georgia Insurance in 1958, Georgia Insurance was precluded by state law from entering into the credit life business. Georgia Insurance's agency force, however, was demanding an expanded coverage which would include credit life as well as credit accident and health for its customers; thus, the necessity of forming a subsidiary to provide these services. Shortly after Georgia Credit Life began providing these services, the management realized that its capital structure would be increasingly burdened by the substantial volume of business which the company was writing because of the deficits caused by provisional payments of commissions to the agents. As the volume of business increased the ratio of net written premiums to policyholder surplus increased. Reduction of this ratio became necessary if the company was to continue expansion through new business which would further burden the surplus. This reduction was accompanied by entering into the subject Treaty, the terms of which provided for an effective transfer of a portion

[6] This contingency never actually occurred during the life of the Treaty in question.

of the burden to Georgia Insurance's capital structure. The result was that Georgia Credit Life was thereafter capable of, and in fact accomplished, a threefold increase in the volume of credit accident and health business. This rapid expansion was desirable to increase profits and additionally, to provide the inexperienced management team with a firmer basis for loss prediction by improving the reliability of actuarial averages.[7]

An additional business purpose for entering into the Treaty was that it tended to insure the solvency of Georgia Credit Life by protecting its surplus from depletion through payment of excessive losses. For in the event of excessive losses, which in reality reinsurance is designed to protect against, 60% (later 70%) of the liability would be satisfied initially from the excess surplus held by Georgia Insurance. Although these losses would eventually be recaptured, the recapture would entail no surplus drain but rather an adjustment to Georgia Credit Life's reinsurance commissions which were calculated with reference to earned premiums. Thus, the capital structure of Georgia Credit Life was insulated against the risk of excessive losses and in such event the company would remain solvent enabling it to recoup commission losses through retroactive adjustment of provisional commissions paid to its agents.

The subject Treaty also inured to the advantage of the policyholder in that the arrangement subjected the substantial surplus of the parent company to policyholder claims. This was a particularly valuable protection should the subsidiary become insolvent because the insolvency clause of the Treaty, which was required by state law, provided for

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[7] Loss prediction in the credit accident and health industry is based upon average loss experiences. The reliability of these averages improves with an increase in the number of persons covered by a particular company. This is true because maximizing the sample minimizes the impact of unusual single losses with respect to the overall averages.

continued liability of the parent for 60% (later 70%) of the claim. It is noteworthy that this arrangement was approved by the Insurance Commissioner of the State of Georgia whose regulatory function is geared to protection of the policyholder.

The Reinsurance Treaty in question was under terms comparable to, and patterned after, reinsurance rates and terms that are usual in the industry between companies dealing at arms length. The advantages accruing to Georgia Credit Life pursuant to the Treaty would have been the same regardless of the reinsurer. The obvious advantage to the parent, Georgia Insurance, was an increase in investment income corresponding to its reinsurance premium.

The accounting methods utilized by Georgia Credit Life under the Treaty were consistent with standard insurance accounting principles and practices. There is irrefutable logic in the assertion that the reserves should follow the premiums.

Conclusions of Law

A "life insurance company" as defined by § 801(a) of the Internal Revenue Code of 1954 is an insurance company whose life reserves, which are required to be maintained by state law, comprises more than 50% of its total reserves. *See* 26 U.S.C. § 801(a), n.2, *supra*. Under standard insurance principles, life reserves are required to be maintained by the insurance company in custody of the unearned premiums received as consideration for life coverage. Similarly, accident and health reserves are required to be maintained by the company holding the unearned premiums received as consideration from the policyholder for accident and health coverage. *See Economy Finance Corp.* v. *United States*, 30 AFTR 2d 72-54446, ¶ 72-5135 (S.D. Ind. 1972). An insurance company may reinsure all or a portion of its risk with a qualified reinsurer and take a deduction from its reserve liability in an amount corresponding to the amount

of insurance ceded so long as the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer. *See* Ga. Code Ann. § 56-413.[8] An agreement providing for cession of a quota share of the premiums whereby the assuming company accepts a quota share liability and sets up the reserve thereon may not be ignored by the Internal Revenue Service for tax purposes if there were legitimate business purposes for entering into the agreement. The fact that favorable tax advantages would inure to the parties to such an agreemment is an insufficient basis for ignoring the agreement even though such advantage may have been a major motive for entering into the agreement. *Alinco Life Insurance Company* v. *United States*, 373 F.2d 336 (Ct. Cl. 1967).[9]

The transaction which is the subject of this litigation, having been found to have been entered into for legitimate business purposes, was a valid business transaction which is entitled to recognition by the Internal Revenue Service for tax purposes. The deduction taken by Georgia Credit Life from its credit accident and health reserve liability in the amount of the credit accident and health reserve liability set up by Georgia Insurance pursuant to cession of premiums under the subject Treaty was a proper accounting procedure accurately reflecting a valid business transaction. Georgia Insurance properly maintained the accident and health reserve liability required to be held against the unearned premiums ceded.

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[8] Ga. Code Ann. § 56-413(5) provides: " . . . full credit shall be allowed a ceding insurer, as an asset or as a deduction from liability, for all reinsurance which may be in effect. . . ."

[9] "Yet, even a 'major motive' to reduce taxes will not vitiate an otherwise valid and real business transaction." 373 F.2d at 343. Citing *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451, 455, 70 S.Ct. 280, 94 L.Ed. 251 (1950).

During the years 1961 through 1964 inclusive, the life insurance reserves properly maintained by Georgia Credit Life comprised more than 50% of its total reserve. Accordingly, Georgia Credit Life qualified as a "life insurance company" during that time under § 801(a) of the Internal Revenue Code of 1954. The results of its operation for those years may not be included in the consolidated corporation income tax return filed by the taxpayer, First Railroad & Banking Company of Georgia.

Order

The Court, having heard this matter without a jury, and having received and considered evidence in the form of depositions, stipulations of fact, documentary evidence and oral testimony, has determined that the plaintiff, First Railroad and Banking Company of Georgia is entitled to a judgment as prayed for in the complaint herein.

The parties have stipulated that the amount of refund due the plaintiff shall be determined by the Internal Revenue Service, subject to approval of the plaintiff's legal representative. If the parties cannot agree upon the computation made by the Internal Revenue Service pursuant to this Order, the matter will be resolved by the Court. Therefore, entry of judgment will be withheld pending a proper determination of the amounts due the plaintiff. This action will be retained on the docket for entry of judgment, or such other orders as justice may require.

It is so ordered, this 7th day of April, 1973.

/s/ Anthony A. Alaimo
United States District Judge